SYNBIOTICS CORP
Form 10-Q
August 14, 2003
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U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2003

OR

o **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 0-11303

SYNBIOTICS CORPORATION
(Exact name of registrant as specified in its charter)

California	**95-3737816**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
11011 Via Frontera San Diego, California	**92127**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (858) 451-3771

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No o

As of August 14, 2003, there were 20,024,944 shares of our common stock outstanding.

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SYNBIOTICS CORPORATION

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

Synbiotics Corporation
Condensed Consolidated Balance Sheet

	June 30, 2003	December 31, 2002
	(unaudited)	(audited)
Assets		
Current assets:		
Cash and equivalents	$ 1,035,000	$ 869,000
Accounts receivable	2,339,000	2,455,000
Inventories	5,017,000	5,438,000
Other current assets	974,000	673,000
	9,365,000	9,435,000
Property and equipment, net	1,365,000	1,409,000
Goodwill	1,397,000	1,397,000
Intangibles, net	2,485,000	2,737,000
Other assets	598,000	458,000
	$ 15,210,000	$ 15,436,000
Liabilities and Shareholders Equity:		
Current liabilities:		
Accounts payable and accrued expenses	3,383,000	$ 4,919,000
Current portion of long-term debt	5,203,000	1,475,000
	8,586,000	6,394,000
Long-term debt		4,516,000
Other liabilities	2,046,000	1,962,000
	2,046,000	6,478,000
Shareholders equity:		
Common stock, no par value, 70,000,000 shares authorized, 20,025,000 and 17,954,000 shares issued and outstanding at June 30, 2003 and December 31, 2002	46,316,000	46,050,000
Series C preferred stock, $1,000 liquidation preference per share (aggregating $2,800,000 at June 30, 2003 and December 31, 2002), 4,000 shares authorized, 2,800 shares issued and outstanding at June 30, 2003 and December 31, 2002	2,604,000	2,604,000
Common stock warrants	1,035,000	1,035,000
Accumulated other comprehensive loss	(569,000)	(958,000)

Accumulated deficit	(44,808,000)	(46,167,000)
Total shareholders equity	4,578,000	2,564,000
	$ 15,210,000	$ 15,436,000

See accompanying notes to condensed consolidated financial statements.

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Synbiotics Corporation
Condensed Consolidated Statement of Operations and Comprehensive Income (Loss) (unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	**2002**	**2003**	**2002**
Revenues:				
Net sales	$ 4,774,000	$ 5,904,000	$ 10,922,000	$ 12,359,000
License fees		75,000		150,000
Royalties	97,000	2,000	99,000	5,000
	4,871,000	5,981,000	11,021,000	12,514,000
Operating expenses:				
Cost of sales	2,340,000	2,880,000	5,303,000	5,722,000
Research and development	291,000	329,000	556,000	689,000
Selling and marketing	988,000	1,107,000	2,052,000	2,354,000
General and administrative	897,000	1,097,000	1,715,000	5,856,000
Patent litigation settlement			(515,000)	
	4,516,000	5,413,000	9,111,000	14,621,000
Income (loss) from operations	355,000	568,000	1,910,000	(2,107,000)
Other income (expense):				
Interest, net	(139,000)	(191,000)	(274,000)	(358,000)
Income (loss) before income taxes	216,000	377,000	1,636,000	(2,465,000)
Provision for (benefit from) income taxes	(8,000)	90,000	13,000	285,000
Income (loss) from continuing operations	224,000	287,000	1,623,000	(2,750,000)
Discontinued operations, net of tax		(5,000)		(71,000)
Income (loss) before cumulative effect of a change in accounting principle	224,000	282,000	1,623,000	(2,821,000)
Cumulative effect of a change in accounting principle, net of tax				(7,649,000)
Net income (loss)	224,000	282,000	1,623,000	(10,470,000)
Translation adjustment	191,000	452,000	389,000	307,000
Comprehensive income (loss)	$ 415,000	$ 734,000	$ 2,012,000	$ (10,163,000)
Basic income (loss) per share:				
Income (loss) from continuing operations	$ 0.01	$ 0.02	$ 0.08	$ (0.23)
Discontinued operations, net of tax				(0.01)

Cumulative effect of a change in accounting principle, net of tax				(0.62)
Net income (loss)	$ 0.01	$ 0.02	$ 0.08	$ (0.86)
Diluted income (loss) per share:				
Income (loss) from continuing operations	$ 0.01	$ 0.02	$ 0.04	$ (0.23)
Discontinued operations, net of tax				(0.01)
Cumulative effect of a change in accounting principle, net of tax				(0.62)
Net income (loss)	$ 0.01	$ 0.02	$ 0.04	$ (0.86)

See accompanying notes to condensed consolidated financial statements.

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Synbiotics Corporation
Condensed Consolidated Statement of Cash Flows (unaudited)

	Six Months Ended June 30,	
	2003	2002
Cash flows from operating activities:		
Net income (loss)	$ 1,623,000	$ (10,470,000)
Adjustments to reconcile net income (loss) to net cash provided by (used for) operating activities:		
Depreciation and amortization	546,000	558,000
Receivable from patent litigation settlement	(265,000)	
Retention bonus payable in common stock		2,641,000
Cumulative effect of a change in accounting principle		7,817,000
Changes in assets and liabilities (net of acquisitions and dispositions):		
Accounts receivable	247,000	37,000
Inventories	571,000	(827,000)
Other assets	10,000	(201,000)
Accounts payable and accrued expenses	(1,782,000)	(773,000)
Deferred revenue		(150,000)
Other liabilities	80,000	74,000
Net cash provided by (used for) operating activities	1,030,000	(1,294,000)
Cash flows from investing activities:		
Acquisition of property and equipment	(115,000)	(61,000)
Net cash used for investing activities	(115,000)	(61,000)
Cash flows from financing activities:		
Payments of long-term debt	(786,000)	(600,000)
Proceeds from issuance of mandatorily redeemable preferred stock, net		2,603,000
Net cash (used for) provided by financing activities	(786,000)	2,003,000
Net increase in cash and equivalents	129,000	648,000
Effect of exchange rates on cash	37,000	46,000
Cash and equivalents beginning of period	869,000	1,039,000
Cash and equivalents end of period	$ 1,035,000	$ 1,733,000

See accompanying notes to condensed consolidated financial statements.

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SYNBIOTICS CORPORATION
Notes to Condensed Consolidated Financial Statements (unaudited)

Note 1 Interim Financial Statements:

The accompanying condensed consolidated balance sheet as of June 30, 2003 and the condensed consolidated statements of operations and comprehensive income (loss) and of cash flows for the three and six months ended June 30, 2003 and 2002 have been prepared by Synbiotics Corporation (the Company) and have not been audited. The condensed consolidated financial statements of the Company include the accounts of its wholly-owned subsidiary Synbiotics Europe SAS (SBIO-E). All significant intercompany transactions and accounts have been eliminated in consolidation. These financial statements, in the opinion of management, include all adjustments (consisting only of normal recurring accruals) necessary for a fair presentation of the financial position, results of operations and cash flows for all periods presented. The financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K filed for the year ended December 31, 2002. Interim operating results are not necessarily indicative of operating results for the full year.

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Note 2 Going Concern:

The accompanying condensed consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The Company incurred a net loss of $14,401,000 during the year ended December 31, 2002, and had an accumulated deficit of $44,808,000 as of June 30, 2003.

As of June 30, 2003, the Company had an outstanding principal balance under its bank debt totaling $5,203,000, of which $875,000 will be paid in monthly installments through January 1, 2004 and the remaining $4,328,000 is due and payable on January 25, 2004. The Company believes that its cash flow from operations will be insufficient to meet its January 25, 2004 obligation; and that the Company will have to restructure or refinance the bank debt, or obtain additional capital. These factors raise substantial doubt about the Company s ability to continue as a going concern for the near term. The condensed consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amounts and classification of liabilities that might be necessary should the Company be unable to continue as a going concern.

The Company believes it will be able to restructure or refinance the bank debt, and is planning on beginning the restructuring process in the second half of 2003. However, no assurance can be given that the Company will be successful in this effort.

Note 3 Discontinued Operations:

In August 2002, the Company sold its instrument manufacturing operations, located in Rome, New York, to Danam Acquisition Corp., located in Dallas, Texas. In November 2002, the Company terminated the license agreement for its PennHIP® operations, located in Malvern, Pennsylvania, and transferred all of the assets related to the PennHIP® operations to the University of Pennsylvania.

The Company has restated prior amounts related to the disposed operations. A reconciliation of the restated amounts for the three and six months ended June 30, 2002 is as follows:

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SYNBIOTICS CORPORATION
Notes to Condensed Consolidated Financial Statements (unaudited)

	Three Months Ended June 30, 2002	Six Months Ended June 30, 2002
Amounts previously reported in:		
Net sales	$ 214,000	$ 455,000
Cost of sales	(150,000)	(376,000)
Research and development	(53,000)	(103,000)
Sales and marketing	(15,000)	(30,000)
General and administrative	(6,000)	(32,000)
Provision for (benefit from) income taxes	5,000	15,000
Discontinued operations, net of tax	$ (5,000)	$ (71,000)

Note 4 Inventories:

Inventories consist of the following:

	June 30, 2003	December 31, 2002
	(unaudited)	(audited)
Raw materials	$2,722,000	$2,621,000
Work in process	449,000	415,000
Finished goods	1,846,000	2,402,000
	$5,017,000	$5,438,000

Note 5 Goodwill and Other Intangible Assets:

The Company has allocated all of its goodwill to its only reporting unit, which is also its only reportable segment (Note 9). Changes in the carrying amount of goodwill were as follows:

Balance at December 31, 2001	$ 12,074,000
Impairment loss	(10,633,000)
Effect of currency exchange rates	(44,000)
Balance at December 31, 2002 and June 30, 2003	$ 1,397,000

Other intangible assets were as follows:

	June 30, 2003		December 31, 2002	
	Gross Carrying Value	Accumulated Amortization	Gross Carrying Value	Accumulated Amortization
Patents	$ 4,744,000	$ 2,462,000	$ 4,404,000	$ 1,903,000
Licenses	618,000	415,000	618,000	382,000
	$ 5,362,000	$ 2,877,000	$ 5,022,000	$ 2,285,000

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Notes to Condensed Consolidated Financial Statements (unaudited)

The weighted-average amortization periods for patents and licenses are 9 years and 10 years, respectively, and the weighted-average amortization period for total intangible assets is 9 years. Annual pretax amortization for other intangibles over the next five years is estimated to be as follows:

2004	$ 471,000
2005	438,000
2006	428,000
2007	321,000
2008	321,000
	$ 1,979,000

Note 6 Preferred Stock Dividends:

On March 26, 2003, the Company declared a dividend on the Series C preferred stock totalling $214,000, for dividends accrued and payable as of January 31, 2003. On June 12, 2003, the Company declared a dividend on the Series C preferred stock totalling $53,000, for dividends accrued and payable as of April 30, 2003. Redwood West Coast, LLC (Redwood), the holder of the Series C preferred stock, as permitted by the Certificate of Determination of the Series C preferred stock, elected to receive shares of the Company s common stock in lieu of the cash dividends. As a result, 1,663,000 shares of the Company s common stock were issued to Redwood s distributees on March 26, 2003, and 409,000 shares of the Company s common stock were issued to Redwood s distributees on June 12, 2003.

Note 7 Patent Litigation Settlement:

In November 1998, the Company filed a lawsuit against Heska Corporation in the United States District Court for the Southern District of California alleging that Heska infringed a patent owned by the Company relating to heartworm diagnostic technology. In March 2003, the Company and Heska entered into settlement and license agreements which have resolved all outstanding claims in the lawsuit. As part of those agreements, each party has licensed certain intellectual property rights from the other party, including Heska licensing from the Company the patent relating to the heartworm diagnostic technology. In addition, the Company received $250,000 in April 2003, will receive $265,000 in 24 monthly installments of $11,000 beginning in January 2004 and will receive royalty payments on future sales of licensed canine heartworm diagnostic products. As a result, the Company has recorded a one-time credit to operating expenses totaling $515,000 during the three months ended March 31, 2003.

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SYNBIOTICS CORPORATION
Notes to Condensed Consolidated Financial Statements (unaudited)

Note 8 Income (Loss) per Share:

The following is a reconciliation of net income (loss) and share amounts used in the computations of income (loss) per share:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Basic net income (loss) used:				
Income (loss) from continuing operations	$ 224,000	$ 287,000	$ 1,623,000	$ (2,750,000)
Less cumulative preferred stock dividends	(53,000)	(53,000)	(105,000)	(90,000)
Income (loss) from continuing operations used in computing basic income (loss) from continuing operations per share	171,000	234,000	1,518,000	(2,840,000)
Discontinued operations, net of tax		(5,000)		(71,000)
Cumulative effect of a change in accounting principle, net of tax				(7,649,000)
Net income (loss) used in computing basic net income (loss) per share	$ 171,000	$ 229,000	$ 1,518,000	$ (10,560,000)
Diluted net income (loss) used:				
Income (loss) used in computing basic income (loss) from continuing operations	$ 171,000	$ 234,000	$ 1,518,000	$ (2,840,000)
Add cumulative preferred stock dividends	53,000		105,000	
Income (loss) used in computing diluted income (loss) from continuing operations	224,000	234,000	1,623,000	(2,840,000)
Discontinued operations, net of tax		(5,000)		(71,000)
Cumulative effect of a change in accounting principle, net of tax				(7,649,000)
Net income (loss) used in computing diluted net income (loss) per share	$ 224,000	$ 229,000	$ 1,623,000	$ (10,560,000)
Shares used:				
Weighted average common shares outstanding used in computing basic income (loss) per share	19,821,000	13,738,000	19,198,000	12,362,000
Weighted average options and warrants to purchase common stock as determined by the treasury method	665,000		500,000	

Weighted average common shares issuable upon conversion of preferred stock as determined by the if-converted method	21,797,000	341,000	21,797,000	
Shares used in computing diluted income (loss) per share	42,283,000	14,079,000	41,495,000	12,362,000

Weighted average options and warrants to purchase common stock as determined by the application of the treasury method totalling 344,000 shares have been excluded from the shares used in computing diluted net income (loss) per share for the six months ended June 30, 2002 as their effect is anti-dilutive. In addition, warrants to purchase 250,000 shares of common stock at

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SYNBIOTICS CORPORATION
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$2.00 per share have been excluded from the shares used in computing diluted net income (loss) per share for the three and six months ended June 30, 2003 and 2002, as their exercise price is higher than the weighted average market price for those periods. In addition, the effect of the warrants to purchase 250,000 shares of common stock at $2.00 per share was anti-dilutive for the six months ended June 30, 2002.

Note 9 Segment Information and Significant Customers:

The Company has determined that it has only one reportable segment based on the fact that all of its net sales are from its animal health products. Although the Company sells diagnostic and instrument products, it does not base its business decision making on a product category basis.

The following are revenues for the Company s diagnostic and instrument products:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Diagnostics	$ 4,456,000	$ 5,649,000	$ 10,347,000	$ 11,919,000
Instruments	318,000	255,000	575,000	440,000
Other revenues	97,000	77,000	99,000	155,000
	$ 4,871,000	$ 5,981,000	$ 11,021,000	$ 12,514,000

The following are revenues and long-lived assets information by geographic area:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	2002	2003	2002
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Revenues:				
United States	$ 2,991,000	$ 4,371,000	$ 6,914,000	$ 8,789,000
France	500,000	428,000	1,088,000	1,079,000
Other foreign countries	1,380,000	1,182,000	3,019,000	2,646,000
	$ 4,871,000	$ 5,981,000	$ 11,021,000	$ 12,514,000

	June 30, 2003	December 31, 2002

	(unaudited)	(audited)
Long-lived assets:		
United States	$ 3,385,000	$ 3,401,000
France	2,460,000	2,600,000
	$ 5,845,000	$ 6,001,000

There were no sales to any one customer that totaled 10% or more of total revenues during the three and six months ended June 30, 2003. The Company had sales to one customer that totalled 12% and 10% of total revenues for the three and six months ended June 30, 2002, respectively.

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Notes to Condensed Consolidated Financial Statements (unaudited)

Note 10 Income Taxes:

The Company s provision for income taxes for the six months ended June 30, 2003, is less than the amount expected by applying the Federal statutory rate to income before income taxes, resulting from the Company s utilization of certain Federal net operating loss carryforwards and certain state general business tax credit carryforwards, and the corresponding change in the Company s valuation allowance for deferred tax assets.

Note 11 Stock-Based Compensation:

The Company measures its stock-based employee compensation using the intrinsic value method. The following disclosures present as reported amounts, utilizing the intrinsic value method, and pro forma amounts, after applying the fair value method, related to stock-based awards made to employees that were outstanding as of June 30, 2003 and 2002:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2003	**2002**	**2003**	**2002**
	(unaudited)	(unaudited)	(unaudited)	(unaudited)
Net income (loss):				
As reported	$ 224,000	$ 282,000	$ 1,623,000	$ (10,470,000)
Pro forma	$ 191,000	$ 228,000	$ 1,557,000	$ (10,577,000)
Basic net income (loss) per share:				
As reported	$ 0.01	$ 0.02	$ 0.08	$ (0.86)
Pro forma	$ 0.01	$ 0.02	$ 0.08	$ (0.87)
Diluted net income (loss) per share:				
As reported	$ 0.01	$ 0.02	$ 0.04	$ (0.86)
Pro forma	$	$ 0.02	$ 0.04	$ (0.87)
Stock-based employee compensation:				
As reported	$	$	$	$
Pro forma	$ 33,000	$ 54,000	$ 66,000	$ 107,000

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Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The information contained in this Management s Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this Quarterly Report on Form 10-Q contains both historical financial information and forward-looking statements. Forward-looking statements are characterized by words such as intend , plan , believe , will , would , etc. Historical financial information may not be indicative of future financial performance. In fact, future financial performance may be materially different than the historical financial information presented herein. Moreover, the forward-looking statements about future business or future results of operations are subject to significant uncertainties and risks, including those detailed under the caption Certain Risk Factors , which could cause actual future results to differ materially from what is suggested by the forward-looking information.

Results of Operations

Our net sales for the second quarter 2003 decreased by $1,130,000 or 19% from the second quarter of 2002. The decrease reflects a decrease in our diagnostic product sales of $1,193,000, offset by an increase in our instrument product sales of $63,000. Our net sales for the six months ended June 30, 2003 decreased by $1,437,000 or 12% from the six months ended June 30, 2002. The decrease reflects a decrease in our diagnostic product sales of $1,572,000 offset by an increase in our instrument product sales of $135,000. Sales of our diagnostic products decreased due to the termination of our supply agreement under which Agen Biomedical, Ltd. (Agen) supplied us with certain of our Witness® diagnostic products, as discussed below, and decreases in sales of our poultry diagnostic products, particularly in Europe and the Middle East resulting from uncertainties surrounding the war in Iraq. Our instrument product sales increased primarily due to increased placements of our SCA 2000 blood coagulation timing instrument, and the resulting sales of the related consumables.

In April 2003, we were notified by Agen that Agen was terminating its supply agreement with us due to late payment of invoices for test kits. Agen manufactured certain of our Witness® in-clinic diagnostic products including canine heartworm, feline leukemia, feline heartworm and canine parvovirus. These Witness® products represented $1,167,000 and $2,745,000 of our net sales during the three months ended June 30, 2003 and 2002, respectively, $3,448,000 and $5,365,000 of our net sales during the six months ended June 30, 2003 and 2002, respectively, and $8,069,000 of our net sales during the year ended December 31, 2002. We have notified Agen that Agen did not have the right to terminate the Agreement, and that it acted wrongfully in terminating the Agreement Also, we have paid all of Agen s invoices for test kits.

We have identified an alternate source of supply of the same Witness® products previously manufactured by Agen, and we anticipate having these products available for sale later in 2003. We also believe that in addition to the material impact in the second quarter of 2003, our results of operations will be materially adversely affected for at least the remainder of 2003; and our results of operations and financial condition could be materially adversely affected beyond that period if we are unable to successfully reintroduce the alternate-source products into the market in the anticipated timeframe.

We recognize revenue from product sales when title and risk of loss transfers to our customer, which is generally upon shipment. Amounts we charge to our customers for shipping and handling are included in our net sales. We provide promotional discounts and rebates to certain of our distributors. Based upon the structure of these rebate programs and our past history, we are able to accurately estimate the amount of rebates at the time of sale. These rebates are recorded as a reduction of our net sales. We recognize license fee revenue ratably over the license term when we have further performance obligations to our licensee. In the event that we have no further performance obligations to our licensee, we recognize license fee revenue upon receipt.

Our cost of sales as a percentage of our net sales was 49% during the second quarter of 2003 and 2002, and was 49% and 46% during the six months ended June 30, 2003 and 2002, respectively. Our gross margins were negatively impacted during the three and six months ended June 30, 2003 by the decrease in our sales, promotional programs in the first half of 2003 involving free goods, an increase in foreign currency exchange rates in the first half of 2003 compared to the first half of 2002, and the fact that a significant portion of our manufacturing costs are fixed.

Among our major products, our DiroCHEK® canine heartworm diagnostic products are manufactured at our facilities, whereas our WITNESS® in-clinic canine heartworm and feline leukemia diagnostic products and our SCA 2000 instrument products are manufactured by third parties. In addition to affecting our gross margins, outsourcing of manufacturing renders us relatively more dependent on the third-party manufacturers. Agen, the previous manufacturer of certain of our Witness® products, has ceased to supply us with those products. We have identified an alternate contract manufacturer of the same Witness® products previously

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manufactured by Agen, and we believe that the cost of these products will be lower than the cost of those manufactured by Agen.

Our research and development expenses decreased by $38,000 or 12% during the second quarter of 2003 as compared to the second quarter of 2002, and decreased by $133,000 or 19% during the six months ended June 30, 2003 as compared to the six months ended June 30, 2002. The decreases are a result of a cost reduction program that was implemented at the end of the third quarter of 2002. Our research and development expenses as a percentage of our net sales were 6% during the second quarter of 2003 and 2002, and were 5% and 6% during the six months ended June 30, 2003 and 2002, respectively.

Our selling and marketing expenses decreased by $119,000 or 11% during the second quarter of 2003 as compared to the second quarter of 2002, and decreased by $302,000 or 13% during the six months ended June 30, 2003 as compared to the six months ended June 30, 2002. The decreases are a result of a cost reduction program, including reductions in headcount, that were implemented at the end of the third quarter of 2002. Our selling and marketing expenses as a percentage of our net sales were 21% and 19% during the second quarter of 2003 and 2002, respectively, and were 19% during the six months ended June 30, 2003 and 2002.

Our general and administrative expenses during the second quarter of 2003 decreased by $200,000 or 18% as compared to the second quarter of 2002 and decreased by $4,141,000 or 71% during the six months ended June 30, 2003 as compared to the six months ended June 30, 2002. The decrease is primarily due to a cost reduction program, including reductions in headcount, that was implemented at the end of the third quarter of 2002, and favorable effects of foreign currency exchange rates on our intercompany balances. In addition, the decrease during the six months ended June 30, 2003 was also attributable to the non-recurrence of $3,682,000 of retention bonuses that became payable in the first quarter of 2002. Our general and administrative expenses as a percentage of our net sales were 19% during the second quarter of 2003 and 2002, and were 16% and 47% during the six months ended June 30, 2003 and 2002, respectively. Excluding the first quarter 2002 bonus expense our general and administrative expenses would have been $2,174,000 or 18% of our net sales during the six months ended June 30, 2002.

In November 1998, we filed a lawsuit against Heska Corporation in the United States District Court for the Southern District of California alleging that Heska infringed a patent owned by us relating to heartworm diagnostic technology. In March 2003, we entered into settlement and license agreements with Heska which resolved all outstanding claims in the lawsuit. As part of those agreements, each party has licensed certain intellectual property rights from the other party, including Heska licensing from us the patent relating to the heartworm diagnostic technology. In addition, we received $250,000 in April, 2003, we will receive $265,000 in 24 monthly installments of $11,000 beginning in January 2004 and we will receive royalty payments on sales of licensed canine heartworm diagnostic products beginning April 2003. As a result, we recorded a one-time credit to operating expenses totalling $515,000 during the first quarter of 2003.

We have received information that Agen intends to market a canine heartworm in-clinic diagnostic test in the United States that infringes our heartworm patent. If Agen does, we will sue Agen, which would result in us incurring litigation expenses.

Our net interest expense decreased by $52,000 or 27% during the second quarter of 2003 as compared to the second quarter of 2002, and decreased by $84,000 or 23% during the six months ended June 30, 2003 as compared to the six months ended June 30, 2002. The decreases are due to decreases in the prime rate, and to decreases in the outstanding principal balances of our bank debt.

We recognized a provision for income taxes of $13,000 during the six months ended June 30, 2003 as compared to a provision for income taxes of $285,000 during the six months end June 30, 2002. The change is primarily due to the treatment of the retention bonuses as permanent differences between income for financial reporting purposes and tax reporting purposes in 2002. We are limited in the utilization of certain of our Federal and state net operating loss carryforwards. As a result of this limitation, $15,999,000 of our Federal net operating loss carryforwards, and $969,000 of our state net operating loss carryforwards, may expire before they can be utilized. In addition, California has placed a moratorium on the utilization of net operating loss carryforwards for 2003.

In the first quarter of 2002, we adopted Statement of Financial Accounting Standards No. 142 (FAS 142), Goodwill and Other Intangible Assets . In connection with the adoption of FAS 142, we performed a transitional goodwill impairment assessment. As a result of this impairment assessment, we recorded an impairment of $7,649,000, net of income tax benefit of $106,000, which is classified as a cumulative effect of a change in accounting principle in the first quarter of 2002. FAS 142 requires that

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we perform subsequent impairment assessments on annual basis, or on an interim basis if events occur that may cause an impairment of our goodwill and other intangible assets.

Financial Condition and Liquidity

The following table summarizes the future cash payments related to our contractual obligations (other than trade payables) as of June 30, 2003 (amounts are in thousands):

	Total	2003	2004	2005	2006	2007	Thereafter
Long-term debt	$ 5,203	$ 750	$ 4,453				
Operating leases	5,172	435	810	$ 829	$ 668	$ 426	$ 2,004
Other long-term obligations							